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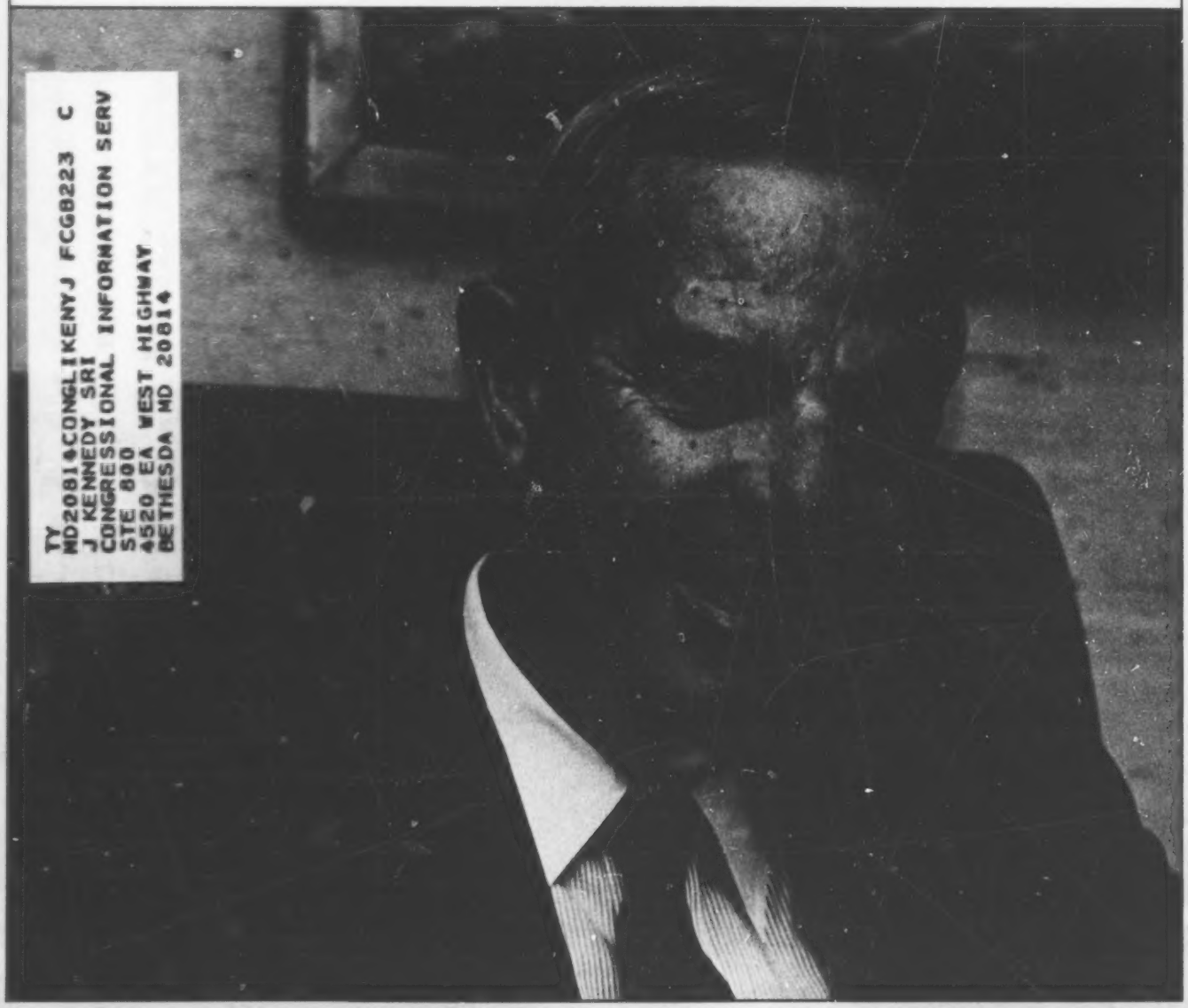

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The interexchange carriers: the view from Wall Street

ROGER P. FAVALE

HOW DOES the financial community currently view the interexchange industry?

First, it is important to provide some definition of the industry and its numerous participants within it. It is important to review the size of the market as it is currently defined and to focus on the factors that will provide the impetus for continued growth. It also is necessary to evaluate the impact that competing communications technologies may have on the long distance market and then to try to determine the opportunities that may eventually present themselves to companies and investors.

The financial community believes the long distance market will continue to grow. It is a market which will hold opportunity for companies to provide a variety of telecommunications services and to manufacture a broad array of carrier and end user equipment. However, the number of companies involved in the interexchange industry has grown dramatically over the last few years. Competition in both the service end as well as the manufacturing end of the business is expected to be fierce. This intense competition may limit access to the capital markets to those companies that can demonstrate an above average management and marketing capability, and a good deal of financial staying power. Bankers and investors are becoming increasingly cognizant of the competition among companies and between technologies, and are becoming more and more selective in their investments.

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Background

Of course, before 1984 all telephone service, both local and long distance, was provided by American Telephone & Telegraph Co. (AT&T) and the Bell System. Even though there were several strong and rapidly growing Independent telephone companies, the dominant Bell system accounted for the vast majority of telephones in place and for almost all of the long distance market.

In the 1970s, with the encouragement of the Federal Communications Commission (FCC), which favored competition in the long distance market, and with the support of the Dept. of Justice (DOJ), which believed that a monopoly should not be maintained solely for monopoly's sake, other common carriers (OCCs) proceeded to expand their networks and to develop a multibillion dollar business. Although OCCs were able to capture a measurable portion of the long distance market, AT&T, with its massive network, continued its market dominance and maintained a 95% share of the business despite the market's extremely rapid growth.

During the next few years, many smaller companies, which today are referred to as resellers, developed another market segment by renting various wide area telecommunications service (WATS) and foreign exchange (FX) lines in bulk from AT&T and then selling them retail to end users at discounts of 25% to 40% to AT&T's direct distance dial (DDD) prices. The more adequately funded and well managed resellers were successful in attracting subscribers and in generating revenues. Some of them attempted at great expense to construct their own transmission facilities to alleviate their dependence upon other carriers for transmission capacity. Others, however, found access to the venture capital community and the capital markets extremely difficult and, as one alter-

Continued on page 37

native, began to consolidate their efforts regionally with other carriers and resellers. One other option that some resellers pursued was to form joint ventures with larger, more established corporations to provide them with the financial and technical strength that the resellers lacked. The trend toward consolidation among resellers which began about 2 years ago is expected to continue as the former entrepreneurial nature of the resale business gives way to major corporate undertakings.

A commodity

The long distance market is a commodity business. It requires a major pooling of financial, technical, managerial and marketing resources within a company to ensure continued growth and profitability. While margins are very low, companies with good market share and efficiently used backbone systems should be able to do well. There are some concerns, however, about the future of a good number of resellers, especially those which are totally facilities-dependent. Increasing costs and price competition are making small resale operations increasingly uneconomic.

However, some of these resellers may be able to play an important role in the future. A fair amount of synergy is being developed between select resellers and operators of newly constructed satellite or fiber optics based networks. These resellers can become local traffic collection entities. Their knowledge of and marketing abilities within their areas of operation can play an important role in increasing the capacity utilization of many of these newly constructed networks, and this interaction will continue and will be mutually beneficial to both parties.

On the equipment side of the business, there are a growing number of mergers and joint ventures among manufacturers, which indicates that a consolidation is also underway in this segment of the industry.

The statistics

As of December 1984, the size of the inter-LATA (local access and transport area) market was approximately $40 billion. At the end of 1984, AT&T reported inter-LATA revenues of approximately $35 billion which represents approximately 88% of the inter-LATA market's revenues but only about 85% of total traffic. The OCCs have done an outstanding job in skimming the market and in capturing 15% of the traffic. The OCCs will be able to continue to increase market share in the near term but they will find it more difficult to do so in the long term as AT&T takes steps to hold on to its highest volume customers.

While the market's traffic grew about 9% in 1984, AT&T is currently projecting that long distance voice transmissions will grow by 10% per year and data transmissions by 15% to 20%. A general consensus among the industry's analysts indicates that by 1990, total inter-LATA revenues will grow to the $60 billion to $70 billion range, depending upon whether a 9% or a 12% growth rate is assumed, and that AT&T's share of the market will settle down in the 70% to 75% range. A recent Arthur D. Little study projects that approximately 20% of the 1990 market will come from the data communications area. This rapid growth in long distance transmissions will be largely attributable to the anticipated decline in long distance prices.

In addition, the interexchange market, as currently defined, may be broadened to include the long distance or toll portion of the intra-LATA market. Various state regulatory agencies currently are undertaking studies to determine whether the intra-LATA toll market should be opened to competition. At the end of 1984, the Bell operating companies (BOCs) reported intra-LATA toll revenues of approximately $9.9 billion and, with a conservative projection of 6.5% annual growth, this market segment alone could add about $14 billion in revenues to the overall long distance market by 1990. This can only enhance the attractiveness of the market to participants and increase opportunities within it.

Access charges

The access charges which the long distance carriers now are paying to local telephone companies are subsidizing local telco operations. There is regulatory and political uncertainty about how this situation will ultimately be resolved. Opportunities will vary depending on the outcome and the timeframe within which new access charges are implemented. Given an accelerated phase-in of access charges, a dramatic decline in long distance prices, which should bring about a major increase in long distance usage, is anticipated. This scenario would provide an impetus to major carriers to accelerate the installation of fiber optic and microwave transmission facilities, and additional switching equipment.

Manufacturers of such equipment and of fiber optic related electronics equipment would be major beneficiaries, as would producers of data communications and end user equipment, since rapid network development and inexpensive data transmission capacity will stimulate the computer area. On the other hand, given a protracted phasing-in of the proposed access charges, development in the long distance public network may be slowed and a good deal of the traffic growth may be accommodated by increases in service bypass facilities and private networks.

Proposed changes in the tax code may adversely impact upon corporate plans for network development as well as investors' appetites for capital intensive projects. The elimination of the investment tax credit would be viewed as an important negative factor for the industry since corporations and investors may be reluctant to commit large sums of money for the construction of these networks without tax benefits.

The players

Looking at the service side of the business, there are an incredibly larger number of industry participants today than there were 10 or even 5 years ago when AT&T was basically synonymous with long distance services. The sheer number of players has not only created some confusion in the minds of end users, it has forced bankers and investors to take a much harder look at individual companies, their products and capabilities, and their long term staying power. How do bankers and investors currently view the industry's composition?

First, they see the category of companies called OCCs, which, according to the FCC, is made up of specialized common carriers (SCCs)

and miscellaneous common carriers. The SCCs are non-telephone companies authorized to provide domestic point-to-point communications services on a common carrier basis. They include such companies as MCI, GTE Sprint, U.S. Transmission Systems, Western Union, Satellite Business Systems, RCA Globecom and American Satellite. The FCC also lists 52 miscellaneous common carriers, which are companies with terrestrial microwave facilities used principally for radio and television transmission services. However, while the miscellaneous common carriers are not directly engaged in providing telephone services, their transmission facilities are leased from time to time by the SCCs as active or back-up transmission facilities.

Next are the Independent telephone companies which, unlike the BOCs, have virtually no restrictions on their interexchange market activities. All of the major Independents—including GTE, United Telecom, Continental, Centel, Alltel and Rochester Tel—already are competing or are planning to compete for some share of this lucrative market as evidenced, in part, by some of their recently announced fiber optics programs and their satellite-based investments.

Then there is the reseller segment. By last tally, the FCC had file numbers for 327 resellers, some of which were totally facilities-dependent while others had either in-place or under construction some type of backbone system. At the end of 1983, the size of the resale market was estimated to be about $700 million. The leaders in the business, together with their approximate market shares are shown in Table 1.

During 1984, a number of resellers either banded together or merged with Independent telcos that already had long distance facilities in place. To cite a few examples; U.S. Telephone became part of United Telecommunications, and Lexitel and LDX agreed to merge. There also was a consolidation of business among American Network (a majority-owned subsidiary of Pacific Telecom), Savenet and CP National's long distance operation. Advanced Telecommunications merged with TA Communications.

This trend will continue as resellers look for merger and acquisition partners to provide the missing elements that are absolutely necessary for long term survivability and profitability. Economies of scale are an important consideratoin today for many of these smaller companies.

Coming into the ring

Major corporations also are entering various niches of the long distance market. Eastman Kodak recently announced its intention to offer value added data networking capacity on its own excess internal facilities. General Motors (GM) recently announced that it will probably enter the telecommunications field. GM has one of the biggest telecommunications networks in the world now and, with the acquisition of Electronic Data Systems and its network, it has excess capacity. General Electric Information Services is continuing its push into the enhanced telecommunications market with a new point-to-multipoint transmission service using frequency modulation (FM) subcarriers to transmit and a value added network to receive data traffic between host and remote computers.

Other corporations are either focusing on specific niche services or are concentrating their efforts in select geographic areas. One example is Argo Communications, which has put together a 12-city satellite-based switched digital network specifically targeted for business voice, data and videoconferencing services. The company also expects to be able to compete effectively in the private line market, to provide transmission capacity for resellers in its service cities, and to link its United States customers with the United Kingdom, France and Spain. Centel, France Cables and Radio, Alltei, M/A-Com, and California Microwave are major investors in this effort. Sears Roebuck, through a subsidiary, is moving ahead with a 26 city videoconferencing network using American Satellite's transponders.

There are also many small to medium sized public manufacturing companies and many small, private, venture capital backed companies addressing specific niches of the long distance communications market. For instance, Equatorial Communications, a small public company, is now offering micro earth stations to corporations that want to set up their own low speed point-to-multipoint data communications networks, which is a cost effective system compared to leased phone lines. Equatorial Communications also has recently announced the purchase of 11 Galaxy III transponders from Hughes Communications; Hughes also will provide Equatorial Communications with access to its terrestrial networks which include earth stations and microwave facilities in New York, Los Angeles, San Francisco, Atlanta, Dallas and Chicago. Private Satellite Network is a private company which is trying to develop a niche business. It has been pioneering the use of small antennas for setting up video and teleconferencing networks. The list of small niche companies just goes on and on.

Furthermore, over the last few years there has been a proliferation on Wall Street of business plans for numerous satellite and satellite-based projects, all basically proposing to increase communications carrying capacity. Proposals have been reviewed for satellites operating in the C-band as well as the Ku-band. There have been proposals for high-powered direct broadcast satellites and lower powered ones for thin route services.

However, all of these proposals require huge investments and long lead times for implementation and, therefore, carry a great risk of misjudging market demand. Many investors and corporations have learned from past experiences that projecting market demand several years out and then implementing a plan to capture it is quite difficult, especially in an industry known for rapid technological change.

In the satellite area, for instance, the anticipated demand for transponders over the last few years has not kept pace with available capacity, and now earthbound technologies are capturing more of the markets which satellites were originally expected to handle. Today, some investors are beginning to re-evaluate the role that satellites will play in long distance communications. Although they are ideally suited for providing telephone service to hard to reach places and though they may still be more economical than the proposed fiber cables for transoceanic links, the tremendous advances in fiber optics may provide an economic alternative to satellites in certain instances.

Fiber optics transmission is of tremendous importance to the long distance industry.

AT&T and MCI, the two major long distance carriers, are the largest players in the fiber optics transmission market. Both companies, however, anticipate using fiber optics systems in conjunction with other

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available technologies to maintain and enhance their networks. In addition to AT&T and MCI, at least eight other companies have announced plans to construct major fiber optics networks, albeit much smaller in scope than the one being built by AT&T. All of these announced networks are similar in terms of features and capabilities, and all propose to offer flawless, high capacity, low cost, digital transmission. However, as these projects attempt to make the transition from blueprint to implementation, only a few will actually be successfully completed.

The companies that have announced major fiber optics programs so far include:

- LDX has announced a 1600 mile network serving the Mississippi River valley and Texas. Kansas City Southern has provided the right-of-way and is a major investor.
- Litel plans to build a 1700 mile network serving the Midwestern and Great Lakes Region. Its first link was established in October 1984. Alltel, Centel, and Pirelli Cable are 32%, 28% and 20% owners, respectively, of LCI Communications, the parent company of Litel.
- RCI plans a 3250 mile network along the Conrail system connecting upstate New York to a 10-state area in the Midwest and using microwave facilities to extend the network into New York City. RCI is a subsidiary of Rochester (N.Y.) Telephone Corp.
- Elektra has announced plans to build a 550 mile network in Texas with a contemplated extension to Chicago. Elektra is a joint venture between Cable and Wireless and the Missouri, Kansas, and Texas Railroad. Its primary marketing focus will be on resellers.
- Fibertrak has announced an 8000 mile carrier's carrier network serving 53 cities which is expected to be completed by 1987. This ambitious program is a $1 billion joint venture between the Santa Fe-Southern Pacific Corp. and Norfolk Southern Corp., two of the nation's largest railroads.
- Microtel is a regional network currently serving portions of the Florida market. The Norfolk Southern Railroad and Centel are major investors in Microtel.
- Lightnet plans to build a 5000 mile network using CSX right-of-way and serving 24 eastern states. Lightnet is planning to sell its circuits on a condominium basis; in other words, the customer will own the circuits but Lightnet will retain management responsibilities. Lightnet is a subsidiary of Southern New England Telephone, a company in which United Telecom owns a 10% share. (Incidentally, United Telecom is also proposing to construct its own fiber optics network.)
- UTCI plans to build a 23,000 mile network linking every LATA nationwide at a currently projected cost of $4 billion. UTCI is a subsidiary of United Telecom. Unlike the other companies, UTCI has the advantage of being able to sell capacity directly within its own organization to U.S. Telephone, which serves residential and smaller business customers, Uninet, which serves corporations and large database operators, and Isacomm, which serves larger corporate customers. [For more information on United Telecom's plans in the long distance market, see the interview with Chairman Paul Henson on p. 26.]

In January, as part of the trend toward consolidation within various niches of the industry, four regional long distance fiber optic network developers reached agreement to interconnect their networks and undertake a joint procurement and marketing effort.

This group, currently called the National Telecommunications Network (NTN), includes Microtel, Southern Net, Litel, Southland Communications and LDX. It is expected to provide service to most of the country east of the Mississippi River, with the exception of Northeast, which will be handled by RCI. RCI has agreed to interconnect with the STN but declined to join the organization.

Risks

From Wall Street's perspective, despite the relatively high growth rate anticipated for the long distance market, questions are beginning to be raised about the possibility of long distance transmission overcapacity if a majority of the announced systems are actually completed. Investors also are voicing other concerns. First, since all of these companies intend to use single mode fibers, which have virtually no bandwidth limitations, further system capacity will only be limited by available electronics at the terminal points and not by cable addition or replacement. Second, the scheduled increases in the number of satellite transponders over the next serveral years will further exacerbate the overcapacity situation. Since the bulk of the proposed fiber optics facilities are expected to be completed in 1986, the competition to provide long distance services will greatly intensify.

Investors' concerns will have a direct impact upon the availability of risk capital for at least some of these projects. They will also reduce the likelihood that major system users will enter into long term contracts with the carriers, since overcapacity should eventually produce lower prices. Finally, it may become increasingly difficult for companies to obtain suitable financing for their proposed long distance projects.

Thus, in summary, the long distance telecommunications industry is expected to grow very rapidly and should provide ample opportunities for both service companies and manufacturing companies. As equal access is implemented, there will be a brief window of opportunity for market participants to court subscribers and increase market share. The interexchange industry will continue to be capital intensive and can be expected to be fiercely competitive. This keen competition will probably continue into the late 1980s, and will result in an increase in marketing and operating expenses for its participants as they strive to gain market share. Therefore, a fair amount of pressure on operating margins and profits can be anticipated.

The need for capital will increase as carriers construct new or augment older transmission facilities. In all likelihood, there will be an increasing reliance on debt financings which may strain the balance sheets of weaker companies. Financial strength will be a key element for survival. Companies may need longer investment horizons and will need staying power to be able to wait for market demand to materialize.

While overcapacity may present some problems for the carriers, it may give enterprising resellers some breathing room. Well established customer bases and efficient use of new and existing networks will become increasingly important. Company managements will have to be able to respond quickly to rapidly changing economic conditions, political pressures, market demands and regulatory developments.

Smaller companies will, of necessity, have to diversify and expand the scope of their services. The trend toward regionalization, consolidation and joint ventures among carriers, resellers and equipment manufacturers will continue. □